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Insurance on the lives of executives

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the capital is used to encourage foreign trade or is invested in domestic enterprises which are fundamentally sound.

The success of an investment trust rests primarily in the management of the portfolio. The personnel of the management, therefore, is of paramount importance. In addition to the necessity for opportune purchasing and selling of securities, it is essential that the fund be augmented through reinvested earnings. A reserve built up in this manner at compound interest will permit the payment of substantially increased dividends in later years.

Although special emphasis is made of the advantages of investment trusts to small investors, the investment trust, if properly managed, affords an opportunity to any one desiring to be relieved of the burdens of supervising his investments to obtain safety of principal through diversification, a good average yield, and marketability. The difficulties which endowed institutions and others in charge of trust funds have incurred in maintaining the principal in the face of a depreciating currency call for careful investigation by trustees in general as to the long term investment possibilities of investment trusts.

Those persons who for one reason or another have developed a keen interest in investment trusts are referred to *Investment Trust Organization and Management*, by Dr. Leland Rex Robinson, which so far is the only book in American literature which attempts to give a comprehensive discussion of the problems arising in the operations of investment trusts.

Insurance On the Lives of Executives

IN an effort to minimize possible losses a business organization ordinarily carries insurance to provide against losses from fire, water, cyclone, theft, accident, and other hazards. But to limit insurance to the conservation of tangible assets is only partial protection. The success of an enterprise often is due principally to the ability of the executives who have the direction of the resources at their disposal. That a business organization may suffer a loss through the death of an executive is no longer questioned. The rule that the beneficiary has an "insurable interest" only when he is a near relative or a dependent has been discarded. It is not only permissible but expedient that a company should protect itself against the loss of a highly valued executive.

So-called "business insurance" is a particular application of the principle of security against loss through distribution of risk which is embodied in every form of insurance. Its function is to indemnify the business concern against the loss of earning power of an important officer in a manner similar to the protection given to a man's family of life insurance. That earning power may be founded on various qualities, such as peculiar managerial ability, technical knowledge, or character. That a fire will occur before the useful life of a building ceases is problematical, but that an individual will die some time is certain. If the former type of contingency warrants insuring, certainly the latter does.

The stupendous valuations which are frequently (and legitimately) attributed to good-will in many instances reflect the earning power of executive brains. It is only logical that the income from good-will be protected as well as the returns from any tangible asset.

Business insurance is applicable to any type of organization, whether it be single proprietorship, co-partnership, or corporation. The man who is in business for himself may be solely responsible for the success of his business. He may wish to protect his family against his premature death, especially if he is making a venture of a speculative nature which he feels sure of carrying through should he live.

In the case of co-partnerships or close corporations insurance is one of the best ways to create a fund to purchase the decedent's interest upon the death of any member. In this way stock of a corporation may be purchased which would otherwise become inactive in the hands of those who are interested only in dividends. It may be desirable to prevent the decedent's heirs from interfering with the management of the business.

It is not uncommon to hear a banker remark that the best security for a loan is the character of the borrower. Because of this fact business insurance may function as a promoter and stabilizer of credit. When large sums are lent to persons whose principal assets are character and ability, it is to the interest of both borrower and lender to avert a financial catastrophe by means of business insurance should death occur before the completion of the project. Considering the large proportion of business which is carried on a credit basis, it is natural that bankers should insist that insurance be provided whenever success is contingent upon the life of any individual.

It is unfortunate that there is no definite basis to determine the value to be placed on the services of an executive. Although personal life insurance has been obtainable for many years, in the absence of reliable data such policies have been purchased in arbitrary amounts. Only during the past year have statisticians determined the economic value of human life. The present value of a man's future personal expenses is deducted from the present value of his future earnings to give the present value of his future net earnings, or the amount for which he should be insured to protect fully his dependents in case of his death. For example, the economic value of a man at age thirty whose maximum salary will be $5,000 a year is estimated to be $48,562. It is to be hoped that further statistical research will result in the determination of a satisfactory basis for estimating the value of executives to a corporation.

Different kinds of policies available for personal life insurance also are available as business insurance. In nearly all cases there is a form of policy to meet the specific needs. The ordinary life policy is the most popular where insurance is to be retained for any length of time. The investment features of endowment policies serve no particular purpose as business insurance to a corporation. The additional funds may be more profitably invested elsewhere. Where insurance is desired for a limited time while a specific project is being completed, term insurance is appropriate. This form of insurance provides the largest protection for the least outlay. It may be had from year to year or for a term of years. However, it becomes expensive if carried to advanced ages. Funds may be borrowed on any type of policy, except term insurance, to the extent that there exists a cash surrender value.

Business insurance, therefore, fulfills an economic need. Insuring the lives of important executives so that sudden casualties will cause as little disturbance in industry as possible is one of the many progressive steps which American business enterprise has taken.

Book Review

Foster, William T., and Catchings, Waddill, *Profits*. (Boston and New York, Houghton Mifflin Company, 1925. 465 p.)

On the theory that the problems of our industrial order as it is today are involved in the money economy and profit economy which we live in, and probably must continue to live in, the authors have followed an earlier volume on "Money" with the present work on "Profits."

trusts probably will cause other states to pass laws concerning the operations of trusts engaged in business. The position of the trust in business then will be defined more satisfactorily as the attitude of the states and courts is revealed through legislation and decisions. The uncertainty of status makes it all the more advisable that the assistance of a competent legal adviser be sought in drafting the trust agreement.

The business trust is likely to take a more important place in the industrial world each year. In principle it should serve adequately the needs of business men in certain fields of industry. Care should be taken to guard against the use of the business trust to shield operations of a questionable character or to evade responsibilities. The trust form of business organization should not be considered as a possible exterminator of the corporation, but should be looked upon as a serviceable expedient to supplement the corporate form of organization in industry.

Insurance on the Lives of Executives

(Concluded)

IN a previous article on this subject the point was made that it is fairly common for a business concern to carry insurance on the lives of its principal executives, especially when the conditions are such that the business would suffer materially from the death of any one of them. Before discussing the accounting and auditing phases of the subject, which is the purpose of this article, two further facts should be brought out, namely, that policies representing such insurance have an investment value and, with the exception of term insurance, also have a cash surrender value. The latter feature, however, usually does not become operative until the policy has been in force for two years.

When the life of an individual is insured in favor of a business concern, the premiums on such insurance paid by the concern may be regarded as advance payments to provide resources with which to indemnify the business for anticipated losses in the event of the death of the individual or to discharge obligations which are expected to arise at that time. The method of handling these payments in the accounts depends to some extent upon the purpose for which the insurance is carried. Frequently, however, the treatment is dependent rather upon the policy of the management with respect to conservatism.

The procedure generally advocated is to consider the cash surrender value of each policy as an asset. Each premium after the second year is divided, a part being debited to the asset account, and the remainder being charged against income. The former share increases and the latter decreases from year to year.

Since insurance is taken essentially to provide for future losses, this plan is open to criticism in that the margin between the face of the policies and the value at which they are carried is reduced each year, thereby lessening the only effective protection against such losses. If the purpose for which the insurance was purchased no longer exists and the policies would be canceled if it were not for their accumulated value, the foregoing procedure might be put into operation without objection.

Assuming that the individual will continue to be identified actively with the business until his death, and that it will be thought desirable to keep the policies in force, the amount of the insurance almost certainly will exceed the premiums paid, and therefore it might seem proper to capitalize all the premiums paid. However, if the object in carrying the insurance is to furnish protection against anticipated losses upon the death of the insured, it is necessary to provide a reserve out of the present profits against which such losses may be charged when they are sustained. Probably the most satisfactory method of obtaining this result is by capitalizing the premiums and concurrently creating a reserve on the books by charging the same amounts to expenses. Then the investment account to be realized upon will be offset by a reserve account against which future losses may be charged. In some respects the same purpose may be accomplished by treating the premiums as expenses when paid, but this practice is open to the objection that it creates a secret reserve which will be disclosed only upon the realization of the insurance.

On the other hand, if the premiums are capitalized without creating a reserve, realization of the insurance will merely have the effect of conversion of one asset—represented by the investment account—into another asset—cash, except as to any excess of the amount recovered over the premiums paid. This difference will have to be accounted for in any event. True, a fund will be made available for distribution in case the business is liquidated, but almost invariably a company taking out insurance on the life of an executive intends to continue in business after the death of the executive. Where the entire premiums are capitalized the company will not be able to apply the proceeds of insurance policies against the decreased earnings anticipated as a result of the death of the insured. In addition to this failure to provide a reserve for expected losses, there is a further objection to this method in that the insurance may be abandoned for one reason or another, and then it would be necessary to write off at one time the excess of the premiums paid over the surrender value of the policy.

Under the plan of capitalizing the premiums and creating an equivalent reserve, it will be necessary, in case of cancellation of the policy, merely to transfer the reserve to the asset account and to credit to profit and loss any recovery on the policies—either the cash surrender value or such value as may be agreed upon in case of assignment to another beneficiary. Although this plan is based on the assumption that the insurance will not be canceled, it is the most conservative plan under any conditions.

In general the asset account representing insurance should not be included in the current assets, although frequently where policies are recorded at their cash surrender value the account is treated as a current asset on the balance sheet. There is some justification for the view that the cash surrender value of policies should be included in the current assets, in that the values at which the policies are carried may be converted readily into cash. However, these assets do not form a part of the working capital. Ordinarily, it is planned that the policies be kept in force until realized in full. Unless there is a definite intention of surrendering them in the near future, they should be excluded from the current assets and carried as investments.

Life insurance policies having a cash surrender value also have a loan value, usually equivalent to the cash surrender value. There should be a clear understanding as to who is entitled to borrow on a policy on the life of an executive wherein the business concern is made the beneficiary. In one instance a concern which had experienced some difficulties was asked to borrow on certain life insurance policies which had been carried on the balance sheet at several thousand dollars. The president of the concern was the insured and the corporation the beneficiary. The president stated that there was no loan value on the policy, for the reason that he himself had obtained a loan on the policies. Further investigation showed that he had a legal right to do so. In policies more recently issued title rests clearly with the corporation and the borrowing privilege is confined to the corporation as beneficiary or, in any event, the consent of the corporation is necessary before the insured can obtain a loan. However, the auditor should investigate the provisions in each policy concerning the privilege of borrowing.

There are three principal methods followed by life insurance companies in the granting of loans. According to one method the policy is retained by the insurance company until the loan is liquidated. Another method requires the endorsement of the insurance company on the policy but the policy may remain in the custody of the insured. In still another method the loan may be granted without requiring the deposit of the policy either for endorsement or for the duration of the loan. Under the first two methods the auditor's attention will be called to the fact that the policy has been pledged as security for a loan. However, because of the last method of granting loans and because of the fact that the insurance company necessarily may not be the pledgee, confirmation of the status of the policies with respect to loans and assignments should be obtained in all instances by correspondence with the insurance company.

Recent Additions to the Library

OUR Executive Offices Library, located at 30 Broad Street, New York, contains about 2,500 books and 5,000 pamphlets. The library is for the use of all members of our organization and our clients. During the year 1926, approximately 1,600 books were circulated, 1,100 reference questions answered, and 1,900 books consulted in the library.

The following books have been added to the library since June, 1926:

Ayer, Leslie J. *Cases on Business Law.* (Seattle, University of Washington Book Store, 1925. 463 p.)

Bailey, Warren G. and Knowles, D. E. *Accounting Procedure for Public Utilities.* (Chicago, A. W. Shaw Company, 1926. 471 p.)

Bolton, Reginald Pelham. *From Sheep Pasture to Skyscraper.* (New York, Equitable Trust Company, c1926. 38 p.)

Britton, William Everett and Bauer, R. S. *Cases on Business Law.* (St. Paul, West Publishing Company, 1922. 1563 p.)

Bruère, Henry and Lazarus, Arthur. *Applied Budgeting.* (Chicago, A. W. Shaw Company, 1926. 248 p.)

Conant, Luther. *A Critical Analysis of Industrial Pension Systems.* (New York, The Macmillan Company, 1922. 262 p.)

Cook, William W. *The Principles of Corporation Law.* (Ann Arbor, The Lawyers Club, 1925. 815 p.)

Crow, William H. *Corporation Secretary's Guide.* (New York, Prentice-Hall, 1926. 764 p.)

Dewing, Arthur Stone. *The Financial Policy of Corporations.* Revised Edition. (New York, The Ronald Press Company, c1926. 1281 p.)

Dice, Charles Amos. *The Stock Market.* (Chicago, A. W. Shaw Company, 1926. 667 p.)

Drummond, Isabel. *Corporate Resolutions.* (New York, The Ronald Press Company, c1926. 321 p.)

Estrich, Willis A. *The Law of Instalment Sales of Goods.* (Rochester, The Lawyers Co-operative Publishing Company, 1926. 1605 p.)

Farrell, Hugh. *What Price Progress?* (New York, G. P. Putnam's Sons, 1926. 323 p.)

Fisher, Irving. *Mathematical Investigations in the Theory of Value and Prices.* (New Haven, Yale University Press, 1926. 126 p.)

Frederick, J. George. *Modern Industrial Consolidations.* (New York, Frank-Maurice, Inc., 1926. 397 p.)

Garnsey, Gilbert. *Holding Companies and their Published Accounts.* (London, Gee & Company, 1923. 208 p.)